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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C. 20554

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JUN 21 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of:	)	
	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
	)	
Rate Regulation	)	

PETITION FOR RECONSIDERATION OF TIME WARNER ENTERTAINMENT COMPANY, L.P.

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SUMMARY

The rules adopted by the Commission implementing the rate regulation provisions of the 1992 Cable Act contain a number of substantive errors which are at odds with the plain language of the 1992 Cable Act and threaten to undermine the financial stability of the cable industry. Accordingly, Time Warner asks that these rules be reconsidered, beginning with the FCC's failed effort to establish workable, and fair, competitive benchmarks. While benchmarks are not inherently inconsistent with the Act, the methodology used to calculate the competitive differential (upon which the benchmarks are based) is so fatally flawed that the benchmarks cannot lawfully serve as a legitimate basis for regulation. In fact, the FCC's price per channel measurements could be wrong by as much as 25% in either direction.

This error is severely compounded by the Commission's decision to apply these arbitrary benchmarks to both basic and non-basic service on a tier neutral basis. The plain language of the Act and its legislative history reveal that Congress intended comprehensive regulation of the basic service tier to ensure reasonable rates. In contrast, Congress set forth a "bad actor" approach to regulating cable programming service rates, targeting only <u>the small minority of operators</u> with unreasonable cable programming service rates. The tier neutral approach adopted by the FCC ignores this clear statutory directive, and as a result, will improperly subject approximately 75% of all cable operators to regulation of their cable programming service rates. This far exceeds the "small minority" of operators Congress intended to regulate.

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The FCC should also reconsider its narrow reading of the Act as it relates to determining whether effective competition exists. The Commission correctly ruled that under the test for effective competition, the 15% threshold may be achieved on a cumulative basis; however, there is no support for the Commission's qualification that only those competing multichannel video providers who offer programming to at least 50% of the households in the franchised area should be included in the cumulative measurement. The plain language of the statute indicates that the two tests are to be considered independently.

In addition, the level of regulatory scrutiny of the equipment rates should be based on whether the equipment is necessary to deliver the service requested by the subscriber. The 1992 Cable Act clearly distinguishes between regulation of equipment used to receive basic service and equipment used to receive per-channel service. Yet, the rules adopted by the FCC regulate all equipment used to receive the basic service tier regardless of whether such equipment is additionally used for per-channel service. This is inconsistent with the Act, will inhibit technological progress, and could cause some subscribers to be saddled with more than one converter box per TV set.

installation. This approach, however, results in an arbitrary and unfair distinction between a system which has undertaken significant new construction and incurred high installation expenses, and a mature system with low churn which may have incurred very low installation expenses during the same time period. Moreover, the entire equipment basket concept is unfair in that it builds in significant regulatory lag by not allowing interest of cable operators because it would reduce the amount of contingent liability operators will face.

The Commission correctly ruled that retransmission consent compensation may be treated as an external cost, thereby permitting operators to directly pass on these new costs to subscribers. Yet, the FCC excluded such treatment in the first

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To: The Commission

PETITION FOR RECONSIDERATION OF TIME WARNER ENTERTAINMENT COMPANY, L.P.[1]

Time Warner Entertainment Company, L.P. ("Time Warner"), by its attorneys, and pursuant to Section 1.429 of the Commission's rules, hereby requests reconsideration of the Commission's above-referenced Report and Order.[2] Time Warner submitted Comments[2] in response to the Commission's Notice of Proposed Rulemaking[3] and, accordingly, is a party to this proceeding with standing to file

[1]Time Warner notes that this petition exceeds the 25 page limit of the Commission's Rules. Time Warner is concurrently filing with this petition a request for leave to file in excess of the page limitation.

[2]Report and Order in MM Docket No. 92-266, 58 Fed. Reg. 29553 (1993) (hereinafter "Order").

[2]Comments filed on Jan. 27, 1993 by Time Warner in MM Docket No. 92-266 ("Comments").

[3]Notice of Proposed Rulemaking in MM Docket No. 92-266, FCC 92-544 (released December 24, 1992)("Notice").

this Petition pursuant to Section 1.106(b)(1) of the Commission's rules.[4]

DISCUSSION

I. THE COMMISSION'S BENCHMARK CALCULATIONS CANNOT SERVE AS A CREDIBLE BASIS FOR REGULATION.

The Commission's effort to establish competitive benchmarks is so flawed that it cannot serve as a legitimate basis for regulation. The Commission's Order would regulate the rates for basic cable services and cable programming services based upon an econometric exercise that attempted to arrive at a "competitive differential," that is, the average difference between the rates of cable systems subject to effective competition (as defined in the statute) and a random sample of cable systems nationwide. The Commission's quantitative effort, when held up to the clear light of expert examination, falls far short of accepted statistical analysis. As such, its use is unlawful.[5]

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[4]This pleading is submitted without prejudice to Time Warner's claims and arguments in its pending lawsuit challenging various provisions of the Cable Television Consumer Protection and Competition Act of 1992 Pub. L. 102-385, 106 Stat. 1460 (1992) (hereinafter "1992 Cable Act" or "Act"). See Time Warner Entertainment Company, L.P. v. FCC, Civil Action No. 92-2494 (D.D.C. filed November 5, 1992).

[5]See, e.g., Ward's Cove Packing Co. v. Atonio, 490 U.S. 642 (1989); City of Brockings Municipal Tel. Co. v. FCC, 822 F.2d 1153, 1167-72 (D.C. Cir. 1987); Int'l Harvester Co. v. Ruckelshaus, 478 F.2d 615, 641-47 (D.C. Cir. 1973).

As examined in the attached paper from National Economic Research Associates, Inc.,[6] as well as an earlier analysis by NERA submitted by Time Warner last week,[7] the Commission's calculation of a 10% competitive differential is wholly unreliable. The Commission's econometric analysis produces a single, broad industry average differential. In so doing, it fails to account for the quantitatively proven fact that the competitive differential itself varies dramatically across system sizes. As NERA has demonstrated, the competitive differential of the large systems (10,000 or more subscribers) is only 3%, and this differential is <u>not statistically significant from zero.</u> Moreover, the error of applying a 10% differential to these systems, when in fact it cannot be demonstrated that there is any differential <u>at all</u>, will affect 75% of all cable subscribers, and thus the major share of the cable industry's revenue base.

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[6]Lewis J. Perl, Linda McLaughlin, Jonathan Falk, "Econometric Assessment of the FCC's Benchmark Model," June 18, 1993 (hereinafter "NERA"). Dr. Daniel Kelley of Hatfield [illegible]

NERA also shows the high standard error in the FCC's calculations: this high degree of error makes the model grossly inaccurate. By omitting variables that determine price and that correlate with the competitive measure, the Commission's price per channel measurements could be wrong by as much as 25% in either direction. This leads NERA to conclude that "[t]he average probability that observations above the benchmark have been misclassified is 29 percent."[8] Applying this probability to all community units nationwide, "6,800 cable franchises will likely be mistakenly classified as requiring regulation. . . ."[9] Calculations featuring such a wide swing provide an utterly arbitrary and unusable basis for regulation, and must be reconsidered. The use of inherently arbitrary numbers, as discussed in the following section, is made all the worse by applying them to all tiered services.

II. THE COMMISSION'S "TIER-NEUTRAL" RATE REGULATION SCHEME VIOLATES THE ACT.

Time Warner and others demonstrated in their comments in the initial phase of this proceeding that the language of the statute requires the adoption of two substantively different rate schemes for basic service and cable programming services -- a comprehensive regulation of basic service and a "bad actor" approach to cable programming services regulation that targets only the minority of operators that have unreasonable cable programming services rates.[10] Instead, ignoring the statutory language, the Commission adopted a tier-neutral scheme to regulate basic service and cable programming services rates. In doing so, the Commission has concluded that at least 75% of all cable operators have unreasonable cable programming services rates.[11] As discussed below, that conclusion runs counter to Congress' intent.

The legislation that constrains the Commission's actions here makes clear that other than placing those services specifically required to be on the basic tier (i.e., local broadcast signals, non-superstation distant signals, and PEG channels), Congress was indifferent to tier content. More specifically, Congress intended that cable operators would have the discretion to tier channels (subject only to the exception noted above) as they saw fit without governmental direction. Time Warner respectfully submits that there is no legislative or public policy served by a "tier neutral" rule, and further, that it directly contradicts the 1992 Cable Act's design to have only limited regulation of cable programming services.

A. The Plain Language Of The Act Reveals Substantive Differences Between Basic Service And Cable Programming Services Regulation.

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[10]<u>See</u> Comments of Time Warner at pp. 39-43.

[11]<u>Order</u> at ¶ 15.

The plain language of the Act confirms that Congress did not want a tier neutral scheme. Congress could have adopted tier neutral regulation simply by failing to distinguish between basic and cable programming services in the Act. Instead, the Act sets out distinct sections with distinct jurisdictional grants and distinct objectives for the regulation of basic tiers and for the regulation of cable programming services.[12] Section 623(c)(1)(A) instructs the Commission to establish criteria to identify, in individual cases, cable operators that have unreasonable cable programming services rates in order to review specific complaints. In contrast, Section 623(b) directs the Commission to ensure, by formulas or other mechanisms, that basic tier rates are reasonable. It is hornbook law that in construing a statute, its structure is to be used as a key guide.[13] The Commission's approach blithely ignores this, reducing the distinct treatment to one of procedure and forum rather than one of substance.[14]

Confirming that the difference between the two regulatory regimes is indeed one of substance are the factors Congress set forth for applying them. Although some of the factors are common to the regulation of both types of tiers, others are very

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[12]As Dr. Kelley observes, in addition to the plain terms of the Act, it is most "telling" that "there is a sound public policy rationale for this separate legal treatment of the two types of service." Kelley at 3.

[13]See Sutherland Stat. Const. § 46.05 (5th ed.).

[14]Order at ¶ 389.

different.[15] The factors for basic service regulation focus more on costs,[16] while the factors for cable programming services focus on the history of the individual system's rates and the rates of other systems with similar services and features.[17] The latter factors -- focusing on rate increases -- reflect Congress' concern over whether an individual operator's rate adjustments are reasonable without regard to any industry average or "benchmark" and require consideration of a particular operator's rates as compared to the performance of comparable systems <u>even though these systems are also not subject to effective competition</u>. Both factors plainly lead to an outlier approach, as urged to the Commission in Time Warner's initial comments.

Additionally, one of the Act's factors for basic service states the Commission shall not create a scheme that allows joint and common costs of non-basic services to be recovered in the basic service tier:

> [In establishing basic service tier regulations the Commission shall take into account] (iii) only such portion of the joint and common costs (if any) of obtaining, transmitting, and otherwise providing such signals as is determined, in accordance with regulations prescribed by the Commission, to be reasonably and properly allocable to the

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[15]<u>Compare</u> 47 U.S.C. § 543(b)(2) <u>with</u> § 543(c)(2).

[16]<u>See</u> 47 U.S.C. § 543(b)(2)(C)(ii)-(v).

[17]<u>See</u> 47 U.S.C. § 543(c)(2)(A)-(D).

> basic service tier, and changes in such costs;[18]

Because the Commission's tier neutral scheme averages all tier costs into an average per channel rate, it necessarily has included non-basic tier costs in the basic tier.[19] The Commission has thus violated this Congressional directive as well.

Finally, the Commission has ignored the statute by relying on benchmark tables that designate "reasonable" as a discrete

A well-established doctrine employed in the ratemaking jurisprudence for many decades is that of the "zone of reasonableness," reflecting the recognition that no precise number could or need be identified as the "true" reasonable rate.[20] In enacting the rate regulation provisions of the 1992

Notwithstanding the remarkable breadth of its undertaking -- to establish rates for more than 30,000 cable community units, each facing distinct costs -- the FCC nevertheless believed that it could draw a clear line demarcating reasonable and unreasonable rates. But Congress had no such confidence. It established a comprehensive scheme for basic tier regulation, where each franchising authority could decide whether the game was worth the candle, but mandated at the federal level only a reactive regulatory scheme for outlier cable programming services rates.

B. Congress Did Not Find That 75% Of Cable Operators Have Unreasonable Cable Programming Services Rates

The results produced by the unitary rate approach reveal the fundamental inconsistency between the legislative action and its administrative implementation. The Commission estimates that, under its tier neutral benchmarks, 75% of all operators will be subject to complaints.[22] Stated otherwise, the Commission's scheme potentially designates the rates of 75% of all cable operators as unlawful. As reflected by the Act's legislative history, this is qualitatively different than the <u>minority</u> of cable operators that Congress instructed the Commission to target as having unreasonable cable programming services rates.

The House Report states in the section discussing cable programming services rate regulation:

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[22] <u>Order</u> at ¶ 15.

> While most cable operators have been responsible about rate increases in this deregulated environment, a **minority** of cable operators have abused their deregulated status and have unreasonably raised subscriber's rates ... In order to protect consumers, it is necessary for Congress to establish a means for the FCC, **in individual cases**, to identify unreasonable rates and to prevent them from being imposed upon consumers.[23]

In addition, the "background and need for legislation" section of the House Report states:

> The committee finds that rate increases imposed by **some** cable operators are not justified economically and that a **minority** of cable operators have abused their deregulated status and their market power and have unreasonably raised rates they charge subscribers. The committee believes it is necessary to protect consumers from unreasonable cable rates.[24]

The floor debates echoed this approach, including statements by two of the framers of the 1992 Cable Act, Senator Inouye and Representative Markey.[25] In short, the legislative history

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[23]House Report at 86 (emphasis added).

[24]House Report at 33 (emphasis added).

[25]Senator Inouye stated:

> In addition [to basic tier regulation], both S.12 and the conference report include what could be called a **bad actor** provision. The conference report provides that the FCC may regulate, on a case-by-case basis, rates for tiers of programming other than basic if it receives a complaint that demonstrates that a rate increase is unreasonable.

(continued...)

plainly supports a conclusion that Congress only intended for the Commission to target the pricing practices of only a minority of cable operators.

C. The "Tier-Neutral" Approach Is Contrary To Public Policy And Will Reduce Consumer Welfare.

The Commission's decision to regulate both basic cable services and cable programming services under a common, comprehensive scheme is contrary to sound public policy and will have severe negative effects on consumer welfare. While the Commission has focused exclusively on purported short-term, static benefits (i.e., rate reductions), it has failed to examine either the direct costs of regulation or, even more significantly, the indirect costs. In particular, the social costs of tier neutral regulation, as analyzed in detail in the attached paper by Dr. Kelley, are severe.

For example, as Dr. Kelley discusses, pervasive regulation of cable programming services directly threatens the continued

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[25](...continued)

138 Cong. Rec. S14224 (daily ed. Sept. 21, 1992) (emphasis added). Similarly, Representative Markey, introducing H.R. 4850, stated:

> In addition to [basic rate regulation] the bill includes provisions to **rein in the renegades** of the cable industry by requiring the FCC, on a per case basis, to regulate unreasonable rates charged for service.

138 Cong. Rec. E1033 (daily ed. Apr. 10, 1992) (emphasis added).

quality of such services. Miscalculations in the appropriate benchmark, inevitable under the Commission's approach, could be ameliorated substantially through the "safety valve" of applying the competitive benchmarks exclusively to basic services.[26] The removal of the safety valve imposes direct costs to consumers and taxpayers through misapplied enforcement activity, costly cost-of-service proceedings, and the diversion of private resources. The indirect costs, also explored by Dr. Kelley, are reductions in quality (that, among other things, implicate First Amendment concerns), delayed or reduced innovation and investment in infrastructure, and the well known economic inefficiencies that flow from cost-of-service regulation.[27]

III. THE FCC'S NARROW READING OF THE CUMULATIVE MEASUREMENT TEST IN DETERMINING WHETHER EFFECTIVE COMPETITION EXISTS IS INCONSISTENT WITH THE ACT.

Pursuant to Section 623(l)(1)(iii) of the Act, effective competition is achieved when "the number of households subscribing to programming services offered by multi-channel video programming distributors other than the largest multi-channel video programming distributor exceeds 15 percent of the households in the franchise area."[28] The Order correctly

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[26]Kelley at 5-7. Moreover, as NERA's analysis concludes, "the econometric evidence that higher tiers require regulation is much weaker than for the basic tier." NERA at 5.

[27]Kelley at 5, 9-12.

[28]Cable Act § 623(l), 47 U.S.C. § 543(l).

determines that the 15 percent threshold should be determined on a cumulative basis. However, that determination is qualified in a manner so that its application is very narrow. The Order states that "only those multichannel video programming distributors that offer programming to at least 50 percent of the households in the franchise area should be included in this cumulative measurement."[29] This qualification contradicts the statute's plain meaning and the underlying policy and rationale for a cumulative measurement.

Paragraph 36 of the Order recognizes that the plain language of the statute suggests that the number of households subscribing to competitive services should be measured cumulatively. Indeed, the Order agrees "that a cable system experiences competitive pressures regardless of whether 15 percent of the households in the franchise area subscribe to many or only one single alternative service."[30] Notwithstanding this analysis, the Commission has inappropriately limited the reach of the cumulative measurement, relying on CFA's erroneous reading of the statute as well as an apparent concern that a 15% market share could simply indicate "cream skimming." The FCC's analysis and rationale for its narrow interpretation of the cumulative measurement test is unsustainable.

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[29] Order at ¶ 36.

[30] Id.

CFA's argument that the language of Section 623(l)(B)(i) [redacted] measurement is thus unnecessary to achieve the Commission's stated objectives and should be reconsidered.

IV. EQUIPMENT USED TO RECEIVE PER-CHANNEL SERVICE SHOULD NOT BE REGULATED.

Section 76.923(a) of the Commission's rules, as explained in ¶283 of the Order, subjects to regulation all equipment used to receive the regulated basic service tier, "regardless of whether such equipment is additionally used" for unregulated per channel service. Time Warner submits that the level of regulatory scrutiny of the equipment rates should be based on whether the equipment is necessary to deliver the service requested by the subscriber. Time Warner respectfully requests that the Commission reconsider its findings in ¶ 283 of the Order and reform FCC Rule §76.923(a). In particular, equipment that is installed only when the subscriber chooses to have access to unregulated per-channel or per-program services should remain unregulated, even if that equipment also happens to pass signals equipment.[34] In contrast, the 1992 Cable Act does not require the regulation of rates for equipment used to receive per-channel services,[35] which is consistent with the general exemption from rate regulation of per-channel services.[36]

Section 623(b)(3)(A) of the 1992 Cable Act specifically limits actual-cost based equipment regulation to two classes of basic equipment: (1) equipment "used by subscribers to receive the basic service tier," and (2) equipment required for a basic-only subscriber to receive programming on a per-channel or per-program basis pursuant to the anti-buy through provision.[37] If Congress intended all equipment to be priced based on actual cost, there would have been no need to specify that rates applicable to descrambling equipment used to receive pay services by a basic-only subscriber are subject to actual cost regulation.[38] Rather, Congress must have intended that equipment

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[34]47 U.S.C. §543(b)(1).

[35]The single exception to this is the anti buy-through provision, discussed below.

[36]See 47 U.S.C. § 543(1)(2) (definition of "cable programming service" excludes "video programming carried on a per channel or per program basis").

[37]47 U.S.C. § 543(b)(3)(A) (emphasis added); 47 U.S.C. §543(b)(8).

[38]As Time Warner explained in its initial rate regulation comments, Section 623(c)(2) of the 1992 Cable Act specifically regulates equipment used for cable programming services under the "bad actor" standard and not the "actual-cost" standard applicable to basic service equipment. See, Time Warner Comments at 48-56. The FCC's rules should reflect that equipment required (continued...)

required for nonbasic subscribers to receive per-channel service, e.g. an addressable box, would be unregulated, even if this more advanced equipment also tunes the basic tier signals.[39] Moreover, given that many of the service options offered by addressable boxes and other innovative pieces of equipment are far removed from basic cable service, it is plain that Congress could not have intended for the Commission's efforts to keep basic rates reasonable to include the regulation of such equipment.[40]

The technical distinctions between equipment used to receive basic service and equipment used to receive per-channel service

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[38](...continued) for cable programming service should be subject to a "bad actor" standard.

[39]Congress' intent to provide actual-cost regulatory protection only for basic-only subscribers is clear from the legislative history. See, House Report at 83 (House intends that FCC regulate "equipment necessary for subscribers to receive the basic tier."); Conference Report at 64 (Conference committee amended House Bill language to ensure that basic subscribers will be adequately protected but retained limit on regulation to equipment for basic subscription use.).

[40]For example, several equipment providers have begun to offer personal computing modules that would be integrated into the converter box. These experimental modules will offer such services as interactive home shopping, interaction with multimedia databases, or these modules can serve as a platform from which the cable operator can decide which software packages to offer. See, "GI, Intel, Microsoft Ink Set-top/Converter Deal," Multichannel News, vol. 14, no. 18, pp. 1, 45 (May 3, 1993); Associated Press Online Service, EDT V0963 (New York, June 13, 1993) (Companies expected to propose hardware and software computing services for set-tops). Obviously, Congress could not have meant for this burgeoning technology to be regulated like the simple tuning equipment provided for basic tier services pursuant to Section 623(b)(3).